DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 03-0406
Indiana Corporate Income Tax
For the Years 1997, 1998, and 1999

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ISSUES

I. Royalty Payments as Business Expenses.

Authority: IC 6-3-2-2(l); IC 6-3-2-2(m); Gregory v. Helvering 293 U.S. 465 (1935); Lee v. Commissioner of Internal Revenue, 155 F.2d 584 (2d Cir. 1998); Horn v. Commissioner of Internal Revenue, 968 F.2d 1229 (D.C. Cir. 1992); Commissioner v. Transp. Trading and Terminal Corp., 176 F.2d 570 (2nd Cir. 1949); Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327 (Ind. Tax Ct. 1992).

Taxpayer argues that the Department of Revenue (Department) erred when it disallowed business expenses consisting of royalty payments paid to a related Delaware holding company.

II. Royalty Payment Amounts for 1999.

Authority: IC 6-8.1-5-1; IC 6-8.1-5-1(a); IC 6-8.1-5-1(b).

Taxpayer maintains that the Department's factual conclusion as to the amount of its 1999 royalty payments was erroneous.

STATEMENT OF FACTS

Taxpayer is an out-of-state company which manufacturers and sells electronic parts. As part of its business operation, taxpayer owned patents and trademarks. The patents and trademarks were attributable to inventions originated and produced by taxpayer and its various foreign and domestic affiliates.

Starting in 1991, taxpayer restructured ownership of its intellectual property including the patents and trademarks.

Prior to 1992, the ownership of the patents was held by taxpayer's "Patent Department." The "Patent Department" was one of taxpayer's wholly-owned subsidiaries. Effective September 1, 1992, taxpayer decided to reorganize its business operations and transformed its "Patent

Department" into a separate corporation. Hereinafter, this newly formed "separate corporation" is referred to as the "Delaware holding company."

On September 2, 1992, taxpayer signed an agreement with Delaware holding company conveying and assigning to Delaware holding company all patent ownership rights to "inventions made from time to time by employees of [taxpayer] and . . . in the inventions described in such applications."

The September 2 assignment agreement was preceded by a "License Agreement" signed between taxpayer and Delaware holding company on September 1, 1992. The "License Agreement" granted taxpayer the exclusive right to use Delaware holding company's patents in its business operations. In addition, the Delaware holding company agreed to provide certain services related to the ownership of the patents. Delaware holding company agreed to maintain the patent registrations; investigate and prosecute patent infringements; investigate the "scope of the patents" and applicability of the relevant government property laws; and periodically conduct a "review of all [licensed] patent agreements and patent applications."

In consideration for the right to make use of the patents in its electronics part business, taxpayer agreed to pay Delaware holding company five percent of its sales revenue in the form of royalty fees.

On September 1, 1992, taxpayer and Delaware holding company entered into a second agreement indicating the taxpayer had assigned Delaware holding company rights to particular intellectual property previously licensed to taxpayer's international subsidiaries. Delaware holding company agreed to continue allowing the international subsidiaries the right to make use of this intellectual property. In return, Delaware holding company promised to pay taxpayer a portion of the license fees received from the international subsidiaries.

On January 1, 1993, taxpayer and Delaware holding company entered a third series of agreements in which taxpayer assigned Delaware holding company all of its "foreign trademark and service applications" along with its "common law marks . . . together with the goodwill of the business as symbolized by the marks." In an ancillary agreement, Delaware holding company agreed to license taxpayer the right to use the intellectual property in return for which taxpayer promised to pay Delaware holding company a royalty fee of one percent of its sales revenue.

During 2003, the Department conducted an audit review of taxpayer's business records and tax returns. The review resulted in an assessment of additional corporate income tax. Taxpayer disagreed with the results of the audit and submitted a protest to that effect. An administrative hearing was conducted during which taxpayer explained the basis for its protest. Subsequently, taxpayer determined that it would be appropriate to withdraw its challenge of two of the protested issues. However, taxpayer continues to challenge issues related to the payment of royalties to Delaware holding company. This Letter of Findings results.

DISCUSSION

I. Royalty Payments as Business Expenses.

During 1992 through 1994, taxpayer entered into a series of agreements by which it ostensibly transferred ownership of patents and trademarks to a wholly-owned Delaware holding company. The Delaware holding company agreed to perform certain particularized services in regard to maintaining that intellectual property. In return, taxpayer promised to pay Delaware holding company a royalty fee based upon taxpayer's sales. Taxpayer did so; it paid Delaware holding company approximately $159,000,000 in royalties during 1997, and it paid approximately $164,000,000 in royalties during 1998. Because – at the time of the audit review – exact business expense records were unavailable, the audit review estimated the amount of 1999 royalty payments based upon "the best information available." The audit estimated that taxpayer had paid approximately $121,000,000 in royalties during 1999. On its income tax returns, taxpayer deducted these royalty payments as business expenses.

During the audit review, the Department concluded that the royalty payments were not legitimate business expenses and disallowed the deductions. The audit did so because it found that the deduction "substantially diluted the federal taxable income that would be subject to Indiana adjusted gross and supplemental net income taxes and help[] to create net operating losses." The audit concluded that the royalty payments – and the underlying transfer of the intellectual property to Delaware holding company – were "transaction[s] with no true economic substance."

Taxpayer disagrees maintaining that the royalty payments were arm's-length payments to Delaware holding company for permission to use the patents and intellectual property. According to taxpayer, Delaware holding company is a "viable, substantive corporate entity with its own employees, office space, management, and on going operations." Taxpayer points out that Delaware holding company performs a number of legitimate functions by managing and maintaining the patents and intellectual property. Taxpayer indicates that Delaware holding company performs the following functions:

1. Delaware holding company conducts "clearance investigations" at the time taxpayer produces a potentially patentable new invention.

2. Delaware holding company "prosecutes" all domestic and foreign patent applications; i.e., it takes all the steps necessary to have patents actually issued in response to proposed applications.

3. Delaware holding company initiates legal proceedings related to potential patent infringements.

In addition to the above-listed description of Delaware holding company's responsibilities, taxpayer has provided information purporting to document the fact that Delaware holding company is an actual, honest-to-goodness corporate entity having its own employees, office space, management, and organizational structure all of which are directed toward maintaining and protecting Delaware holding company/taxpayer's patents and intellectual property.

The issue is whether the audit was justified in disregarding the royalty payments for purposes of calculating taxpayer's Indiana adjusted gross income.

IC 6-3-2-2(m) provides as follows:

> In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

In addition, IC 6-3-2-2(l) vests both taxpayers and the Department with authority to allocate and apportion a taxpayer's income within and among the members of a unitary group of related entities.

> If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all of any part of the taxpayer's business activity, if reasonable;
>
> > (1) separate accounting;
> >
> > (2) the exclusion of any one (1) or more of the factors;
> >
> > (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
> >
> > (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Under IC 6-3-2-2(l), the audit was correct in disallowing the claimed business expenses in the form of royalty payments in order to "fairly represent the taxpayer's income derived from sources within the state of Indiana . . . ." Id. Although the information provided by taxpayer does give evidence of the fact that Delware holding performed a legitimate function by protecting the integrity of the patents and intellectual property, both the transfer of those properties to Delaware holding company and the resulting payment of substantial royalties are devoid of economic substance.

Prior to transferring ownership of the patents and intellectual property to Delaware holding company, there is no indication that any determination was made concerning the value of these properties. There is no indication that Delaware holding company gave any consideration in return for receiving ownership of the patents and intellectual property, which – by agreement of both taxpayer and the Department – consisted of property having both present and potential significant value. Instead, taxpayer apparently simply "assigned" these valuable properties to Delaware holding company without receiving any consideration in return. This seemingly arbitrary and one-sided transfer does not indicate that the transfer of the properties was a truly "arms-length" transaction.

In addition, the Delaware holding company was never a disinterested third-party at the onset of the initial property transfer or at the time it agreed to allow taxpayer continued use of the property. Although reconfigured in outward form, the Delaware holding company was at all times simply a wholly-owned division of the taxpayer's business operations. It would appear to be an inescapable conclusion that the patents and intellectual property were simply moved from one corporate pocket into another.

It is also noteworthy that after taxpayer assigned Delaware holding company ownership of the patents and trademarks, taxpayer then began to pay substantial sums of money for permission to use the very property which it once owned. During 1997, taxpayer paid Delaware holding company 159 million dollars; in 1998, taxpayer paid 164 million dollars; in 1999 taxpayer paid an estimated 121 million dollars. During these three years, taxpayer paid approximately $444,000,000 to Delaware holding company. Although it would appear that Delaware holding company is a viable business entity that performs certain legitimate services in connection with the patents and trademarks, the amount paid Delaware holding company seems wildly disproportionate to the services expected of Delaware holding company during this period.

The anomalous royalty payments are better understood in light of the fact that taxpayer and Delaware holding company have entered into a "revolving credit agreement." The agreement between the parties – as of 1999 – allows taxpayer to borrow up to $500,000,000 from Delaware holding company. As the Department understands this credit agreement, taxpayer is entitled to borrow from Delaware holding company the same money it paid in royalties. This conclusion is reinforced by the audit's finding that Delaware holding company paid taxpayer $180,000,000 in dividends to taxpayer during 1997 and paid $215,000,000 in dividends to taxpayer during 1998.

In sum, taxpayer transferred to wholly-owned Delaware holding company ownership of valuable intellectual property without receiving consideration in return. Delaware holding company performed certain services related to protecting the intellectual property. Taxpayer paid millions of dollars in the form of royalties for the right to use intellectual property which it transferred to Delaware holding company. Taxpayer received proportional sums from Delaware holding company in the form of dividends and loans. This arrangement enabled taxpayer to claim business expense deductions for the royalty payments and – presumably – the "interest" paid to Delaware holding company and attributable to the revolving credit agreement.

The Department is led to the conclusion that the audit was correct in disallowing the royalty payments as business expenses. The transfer of the patents and trademarks does not make any business sense. Instead, the transfer of the intellectual property to wholly-owned Delaware holding company, the payment of millions of dollars in the form of royalty payments for the right to use property which it gave away, and the "revolving credit agreement" by which taxpayer retrieved the royalty payments appear to be nothing more than a form of highly-stylized corporate theater.

In addition, the audit would have been justified in disallowing the royalty and interest deductions on the ground that the expenses were incurred as a result of a "sham transaction."

The "sham transaction" doctrine is well established both in state and federal tax jurisprudence dating back to Gregory v. Helvering 293 U.S. 465 (1935). In that case, the Court held that in order to qualify for a favorable tax treatment, a corporate reorganization must be motivated by the furtherance of a legitimate corporate business purpose. Id at 469. A corporate business activity undertaken merely for the purpose of avoiding taxes was without substance and "[t]o hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." Id at 470. The courts have subsequently held that "in construing words of a tax statute which describe [any] commercial transactions [the court is] to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation." Commissioner v. Transp. Trading and Terminal Corp., 176 F.2d 570, 572 (2nd Cir. 1949), *cert denied,* 338 U.S. 955 (1950). "[t]ransactions that are invalidated by the [sham transaction] doctrine are those motivated by nothing other than the taxpayer's desire to secure the attached tax benefit" but are devoid of any economic substance. Horn v. Commissioner of Internal Revenue, 968 F.2d 1229, 1236-37 (D.C. Cir. 1992). In determining whether a business transaction was an economic sham, two factors can be considered; "(1) did the transaction have a reasonable prospect, *ex ante,* for economic gain (profit), and (2) was the transaction undertaken for a business purpose other than the tax benefits?" Id. at 1337.

Taxpayer maintains that the transfer of its intellectual property to the Delaware holding company was made for a legitimate business purpose. Specifically, taxpayer points to the services Delaware holding company performed in protecting and maintaining the value of the intellectual property. However, the legitimate services Delaware holding company performed or in the manner in which Delaware holding company was compensated are not at issue. What is at issue is the validity of the initial transfer of the intellectual property and the consequent royalty payments. In this instance, there is nothing to indicate that the parties ever determined the value of the intellectual property before it was transferred. There is nothing to indicate that taxpayer ever received any consideration for the intellectual property at the time ownership of the property was transferred. There is no indication that the royalty payments were anything more than an arbitrary transfer of sums to a related entity.

The question of whether or not a transaction is a sham, for purposes of the doctrine, is primarily a factual one. Lee v. Commissioner of Internal Revenue, 155 F.2d 584, 586 (2d Cir. 1998). The taxpayer has the burden of demonstrating that the subject transaction was entered into for a legitimate business purpose. IC 6-8.1-5-1(b).

The taxpayer has failed to meet its burden of demonstrating that the transfer of the intellectual property to the Delaware holding company or that the royalty payments subsequently made were supported by any business purpose other than tax avoidance.

Taxpayer is, of course, entitled to structure its business affairs in any manner its sees fit and to vigorously pursue any tax advantage attendant upon the management of those affairs. However, in determining the nature of a business transaction and the resultant tax consequences, the Department is required to look at "the substance rather than the form of the transaction." Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327, 1331 (Ind. Tax Ct.

1992). The transfer of the intellectual property and the royalty payments were purely matters of "form" and lack any business "substance."

FINDING

Taxpayer's protest is respectfully denied.

II. **Royalty Payment Amounts for 1999**.

At the time the original audit was conducted, it was not possible to determine the exact amount of royalty payments taxpayer paid Delaware holding company during 1999 because the payments were "included in broad categories and not broken down to individual expenses and amounts." Instead, the audit computed 1999 royalty payments based upon "the best information available." Based upon that available information, the audit found that taxpayer had paid 121 million dollars to Delaware holding company in the form of royalties during 1999.

Taxpayer now argues that the 121 million estimate was an overstatement of actual 1999 royalty payments. Taxpayer explains that it was not initially possible to provide the audit with more detailed information because it as "insufficiently staffed" and had recently "underwent significant management and staff level changes." Taxpayer maintains that it has subsequently reviewed its 1999 expenses and now finds that it paid approximately $99,000,000 in royalties during 1999.

The audit calculated the 1999 royalties under authority of IC 6-8.1-5-1 which states that, "If the department reasonably believes that a person has not reported the proper amount of tax due, the department shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the department." IC 6-8.1-5-1(a).

The audit report's conclusion as to the amount of taxpayer's foreign source income expenses is presumed correct. "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is correct." IC 6-8.1-5-1(b). The Department is not inclined to overturn the audit's finding as to the 1999 royalty payments based upon taxpayer's say-so because taxpayer has not met its burden of proving that the original assessment is *incorrect*; what taxpayer has done is advance an argument that is not entirely frivolous. The audit division is requested to review taxpayer's documentation and – to the extent taxpayer can substantiate its argument as the amount of 1999 royalties – make whatever adjustment it deems appropriate.

FINDING

To the extent taxpayer can substantiate its argument concerning the amount of royalties paid during 1999, taxpayer's protest is sustained.

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